

ANALYSIS OF ORIGINAL BILL

Author: Leach Analyst: Paul Brainin Bill Number: AB 1828

Related Bills: SB 469 (93/94) Telephone: 845-3380 Introduced Date: 02-12-98

Attorney: Doug Bramhall Sponsor: State Bar
Business Law
Center

SUBJECT: Partnerships/Limited Liability Companies

SUMMARY

This bill would amend the Corporations Code to define domestic limited liability company (LLC) organized in California to be an entity having one or more members (rather than two or more members). This bill also makes other changes to the Corporations Code that do not affect this department.

EFFECTIVE DATE

This bill would be effective January 1, 1999.

BACKGROUND

An LLC is a form of hybrid unincorporated business association which affords its members:

- limited liability to the extent of a member's equity investment;
- flexible management alternatives; and
- liberal membership qualification requirements.

LLCs combine traditional corporate and partnership characteristics. Members of an LLC are afforded the same advantage of limited liability as are shareholders of a corporation.

SPECIFIC FINDINGS

Existing **federal law** does not recognize LLCs.

Federal regulations generally classify each business entity as either a "corporation per se," treated and taxed as a corporation, or an "eligible entity" entitled to elect its classification. Any "eligible entity" that fails to make a proper election will be classified according to default classification rules. The default classification rules classify an eligible entity with two or more owners as a partnership and disregard an eligible entity with one owner.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

3/19/98

Agency Secretary

Date

By:

Date:

Federal regulations provide that certain entities will be treated as a "corporation per se" and always will be taxed as a corporation (subject to specified grandfather rules), such as (1) a business entity organized under a federal or U.S. state statute, *if* the statute describes or refers to the entity as incorporated or as a corporation, body corporate or body politic; (2) a business entity organized under a U.S. state statute, *if* the statute describes or refers to the entity as a joint-stock company or joint-stock association; or (3) an insurance company.

All entities not specified as a "corporation per se" (whether domestic or foreign, incorporated or unincorporated) are treated as "eligible entities" and are entitled to elect their classification as follows:

- If the eligible entity has at least two members it may elect to be classified and taxed as either a partnership or a corporation; or
- If the eligible entity has only one member it may elect to be classified as a corporation or to be disregarded as an entity separate from its owner.

Thus, for **federal** purposes, a corporate-owned single-member LLC which chooses to be disregarded effectively disappears for tax purposes, becoming a division or branch of its corporate parent. An individually-owned single-member LLC which is disregarded is treated as a sole proprietorship.

Current **state law** conforms to the federal entity classification regulations (check-the-box regulations) and generally provides that whatever classification is adopted for federal purposes also must be used for California purposes.

Current **state law**, as set forth in the Corporations Code, allows the formation and operation of LLCs in California. Any person not prohibited by the LLC Act may file articles of organization with the Secretary of State and execute an operating agreement to organize an LLC, which must consist of at least two members. **State law** also legally recognizes foreign single-member LLCs and permits them to register to conduct business in California.

Under **state law**, an LLC that is not classified as a corporation (i.e., classified as a partnership or disregarded) is subject to an annual tax of \$800 and a fee based on gross income.

This bill would allow the formation of single-member LLCs under the Corporations Code. By virtue of being an LLC, a single-member LLC would remain subject to an annual tax of \$800 and a fee based on gross income, unless the LLC is classified as a corporation. If classified as a corporation under the Revenue and Taxation Code, the LLC will be subject to the Bank and Corporation Tax Law for all purposes.

Policy Considerations

Currently, domestic LLCs must consist of at least two members. Foreign single-member LLCs are permitted to register to conduct business in California. This bill would allow the organization of single-member LLCs in California and bring parity in the treatment of foreign and domestic LLCs.

Implementation Considerations

Implementation of this bill would not significantly impact the department.

Technical Consideration

The attached technical amendment is needed to revise the Personal Income Tax Law due to changes made to it pursuant to SB 1234 (Stats. 1997, Ch. 608).

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

On balance, net revenue losses from this proposal would most likely be as follows:

Estimated Revenue Impact of AB 1828 Partnerships / Limited Liability Companies (In \$Millions)			
Fiscal Year	1998-99	1999-00	2000-01
Revenue Impact (Rounded)	(1)	(1)	(1)

Any possible changes in employment, personal income, or gross state product that might result from this proposal are not taken into account.

Tax Revenue Discussion

Revenue effects would depend on the number and type of single-member entities becoming LLCs and the difference between what their tax liability would have been and LLC tax and fees.

Descriptive data for existing limited liability companies are not yet available. Single-member entities that are subject to the Business and Profession Code (except for the insurance agents and brokers) would not qualify. The current law revenue impact of LLC legislation is estimated to be net revenue losses on the order of \$5 million per year.

As with the original analysis for LLC legislation, there would be both revenue gains and losses due to the extension of LLC status to single-member entities, with net losses resulting overall. For example, single-member S-corporations could avoid the entity level tax (1.5% of state net income) and existing LLCs could continue to operate in the event members leave or die, thereby continuing to pay the minimum tax and special fees. On balance, the estimated net revenue losses for domestic single-member LLCs are \$1 million annually.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1828
As Introduced February 12, 1998

AMENDMENT 1

On page 20, after line 9, insert:

Sec. 11. Section 17087.6 of the Revenue and Taxation Code is amended to read:
17087.6. With regard to any limited liability company not classified as a
corporation ~~If a limited liability company is classified as a partnership~~ for
California purposes, a person with a membership or economic interest shall take
into account amounts required to be recognized under Chapter 10 (commencing with
Section 17851).